

15 E*TRADE Financial Corporation — 2011

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ETFC

www.etrade.com

Headquartered in New York City, E*TRADE Financial Corp. is an online brokerage that allows individuals to trade equities, update personal investment portfolios, and obtain information around the clock. E*TRADE receives a commission on each trade and receives the short positions of their clients. The firm has over 4.3 million account holders who hold \$189 billion in customer assets. Clients can trade stocks in person, by phone, or increasingly on the Internet. The company serves international clients worldwide and is positioning itself as more than a brokerage firm. Slowly but surely, E*TRADE is becoming a complete financial services portal and execution portal for individuals by offering a variety of banking and brokerage services.

E*TRADE's first-quarter 2011 net income was \$45 million, reflecting a strong performance in its core business, decrease in provision for loan losses, and improved expense management. In the first quarter, the company's total net revenue increased 3.6 percent to \$536.7 million from \$517.5 million in the prior year. E*TRADE's total daily average revenue trades (DARTs) for the first quarter were 177,000, surging 18 percent. Net new brokerage assets reported were \$3.9 billion in the first quarter, up from \$2.4 billion in the prior quarter and \$2.2 billion in the prior-year quarter. At the end of the quarter, E*TRADE reported 4.3 million customer accounts, which included 2.7 million brokerage accounts. Net new brokerage accounts increased to 51,000 from 48,000 in the prior quarter and 2,000 in the prior-year quarter.

As the stock markets dropped more than 1,500 points on August 8–11, 2011, E*TRADE's business nearly doubled. E*TRADE spokeswoman Susan Hickey reported that her company experienced a 42 percent increase in user log-ins on some of those days, compared to the same days during the prior month. Moreover, mobile traffic (including iPad users) hit an all-time high, more than doubling the July average. Hickey also reported major increases in inbound calls. "People are very engaged right now with what's happening in the market," Hickey said.

History

Founded as a service bureau in 1982 by Bill Porter, a physicist and inventor, the company initially provided online quote and trading services to Fidelity, Charles Schwab, and Quicken. Seeing the opportunity to capitalize on a potentially huge discount brokerage market, Porter became the first to envision allowing individuals to use personal computers to invest in the stock market for less than the traditional brokerage fees. It would take several years for the world to catch up to Bill's vision. In 1992, E*TRADE Securities, Inc. was born and began to offer online brokerage services through America Online and CompuServe. With the launch of www.etrade.com in 1996, the demand for E*TRADE's services exploded.

E*TRADE went public in August 1996 and completed another stock offering in 1997 when Bill handed the reins over to Christos Cotsakos. Under Christos's leadership, E*TRADE became a global leader in online personal financial services with branded websites in 150 countries around the world. The company introduced E*TRADE Bank in 2000 with the purchase of E*TRADE Financial (now E*TRADE Financial), an online bank with more than 100,000 customers. E*TRADE also bought Card Capture Services (now E*TRADE Access), an operator of more than 9,000 ATMs across the United States. Continuing to expand its global reach, E*TRADE acquired Canadian firm VERSUS Technologies, a provider of electronic trading services, and teamed up with UBS Warburg to allow non-U.S. investors to buy U.S. securities with

to trade in dollars. Later, its E*TRADE International Capital announced plans to offer an initial public offering (IPO) to European investors.

In 2001, E*TRADE entered consumer lending when it acquired online mortgage originator LoansDirect (now E*TRADE Mortgage). E*TRADE sold substantially all of its assets and liabilities of E*TRADE Access in 2004. In an attempt to further its dominance in the financial industry in 2005, E*TRADE acquired Harris Direct, formerly a discount brokerage service of Bank of Montreal, and BrownCo, formerly a discount brokerage service of J.P. Morgan. In 2006, Retirement Advisors of America, Inc. (RAA), a Dallas, Texas-based investment advisory company was acquired. RAA manages more than \$1 billion in assets. E*TRADE acquired the start-up social finance company Cake Financial in 2010.

Vision/Mission

E*TRADE's vision statement is: "to empower self-directed investors to make informed investment decisions and take control of their financial future with anytime, anywhere access to the world's major investment markets."

E*TRADE's mission statement is: "to create long term shareholder value through superior financial performance driven by the delivery of a diversified range of innovative, customer-focused financial products and services and supported by an operating culture based on the highest levels of teamwork, efficiency and integrity."

Source: E*TRADE Financial Corp.

The Economy

Despite the best effort of companies in the electronic investment services industry to reduce cyclicity, their business is closely tied to the economy, corporate earnings, technology, and the stock market. During 2011, stock prices are rising, the value of the dollar is falling, unemployment remains high, business profits are high, oil prices remain high, the value of gold is at all-time highs, and emerging economies are presenting millions of new customers every day for interested firms. During the first week of August 2011, the stock market fell over 1,000 points. Volatility, turbulence, and uncertainty plague the market and investors. The national deficit rose to \$1.5 trillion in 2011, the largest deficit in the nation's history.

The U.S. real gross domestic product (GDP) growth is about 2 percent for 2011, down from 2.9 percent in 2010, and the national unemployment rate is about 9 percent. The U.S. housing market continues to struggle with thousands of new foreclosures and short sells becoming available monthly, as home prices continue to slide lower.

In an effort to help the economy, the Federal Reserve in December 2008 lowered the Federal Funds rate to between 0 percent and 0.25 percent. This was the lowest range ever and was maintained through June 2011. Standard & Poor's economists predict the federal funds rate will increase once there is a consistent decrease in the country's unemployment rate. As a result, firms in the financial industry benefitted from these low interest rates. Through January 2011, the S&P Composite Stock Index rose 88 percent since its March 2009 low. Lower interest rates usually equate to higher stock prices. However, for the first time in the history of the United States, S & P in August 2011 downgraded the country's credit rating from AAA to AA.

New regulations have been instituted for the financial industry to help prevent an economic disaster. The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act and the Credit Card Accountability, Responsibility, and Disclosure (CARD) Act of 2009 offer consumers stricter protections from unfair practices as well as increased issuer accountability. E*TRADE faces extensive banking and securities rules and regulations. At the end of February 2010, approximately 7,677 mutual funds were in the United States with approximately \$11 trillion in assets under management, an increase of nearly 15 percent from December 2008.

Competitors

E*TRADE continues to diversify and expand its services beyond online domestic retail brokerage offerings to include banking, global cross-border trading, mutual fund offerings, marketing, consumer lending, institutional investing, financial advice, and insurance. The nature and number of competitors in these varied market places is increasing. E*TRADE faces direct competition from full commission brokerage firms, discount brokerage firms, online brokerage

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firms, pure-play Internet banks, traditional “brick & mortar” commercial banks, and savings banks. These competitors provide touch-tone telephone, voice response, online banking services, electronic bill payment services, and a host of other financial products. In addition, E*TRADE competes with mutual fund companies, which provide money market funds and cash management accounts.

E*TRADE’s main competitors are Fidelity Investments, Charles Schwab (SCHW), and TD Ameritrade (AMTD). Fidelity Investments is a group of privately held companies that is currently the largest broker in the industry with \$5.2 billion in revenue. Schwab is the second largest broker in the industry with revenues totaling \$4.5 billion at year-end 2010. TD Ameritrade has approximately \$2.6 billion in revenues. E*TRADE ranked fourth with \$2.4 billion in revenues. Exhibit 1 presents selected financial information on E*TRADE’s key competitors.

TD Ameritrade

Based in Omaha, Nebraska, TD Ameritrade provides online brokerage services, an Internet-based personal financial management service, touch-tone telephone and market data, and research tools. Ameritrade’s services are very similar to those of E*TRADE. In 2010, Ameritrade reported revenues of \$2.6 billion.

For the company’s second fiscal quarter of 2011, Ameritrade’s daily average revenue trades (DARTs) increased by 16 percent over the same quarter last year to 439,158, which is an increase of 18 percent over the previous quarter. TD Ameritrade also saw its total client assets increase 21 percent to a record \$413 billion. Ameritrade maintained its quarterly dividend of 5 cents per share.

College baseball’s top sluggers competed in the second annual TD Ameritrade College Home Run Derby, hosted at the new TD Ameritrade Park in Omaha on July 2, 2011. Immediately

EXHIBIT 1 Financial Comparison

	E*TRADE	Charles Schwab	TD Ameritrade
\$ Revenue	2.44 B	4.51 B	2.58 B
\$ Market Capitalization	3.98 B	22.32 B	12.47 B
% 5 Year Annual EPS Growth	67.49238	-7.12813	4.20881
Valuation			
Stock Price/Earnings	-123.08	45.03	18.62
Stock Price/Cash Flow	3.58	25.2	14.33
Stock Price/Sales	1.39	4.53	4.36
Per Share Data			
Last Dividend	0	42.11	9.52
\$ Book Value	18.51	5.32	6.95
\$ EPS	0.32	0.58	1.05
Profitability			
\$ EBIDTA	281.13 M	1.12 B	1.12 B
% Operating Margin	1.67%	34.35%	35.69%
% Profit Margin	-1.17%	10.07%	22.96%
Dividend			
% Dividend Yield	0.00%	1.30%	0.46%
Payout Ratio	0	42.11	9.52
% Dividend Yield 5 Year Average	0.00%	1.07%	6.86%
Growth			
\$ Net Income	-28.47 M	454.00 M	592.18 M
\$ EPS	0.32%	0.58%	1.05%

Source: <http://www.dailyfinance.com/company/e-trade-financial-corporation/etfc/nas/top-competitors>.

following the College Home Run Derby, the 27th annual *Omaha World-Herald* fireworks display took place in the stadium.

Internal Issues

Organizational Structure

Donald Layton was appointed CEO of E*TRADE in 2008. Following Mr. Layton as CEO was Robert Druskin in 2009. Then Steven Freiberg became CEO of E*TRADE in 2010. Obviously E*TRADE is having difficulties finding sustainable leadership in top management. The company has been losing money annually and needs a clear strategic plan from somebody.

In attempts to cut costs and streamline the organization as a whole, E*TRADE has reduced the number of people needed to maintain the firm. Currently the company has about 3,000 employees. Exhibit 2 shows E*TRADE's organization chart. Note the CEO is Steven J. Freiberg. Note this is a divisional-by-product structure.

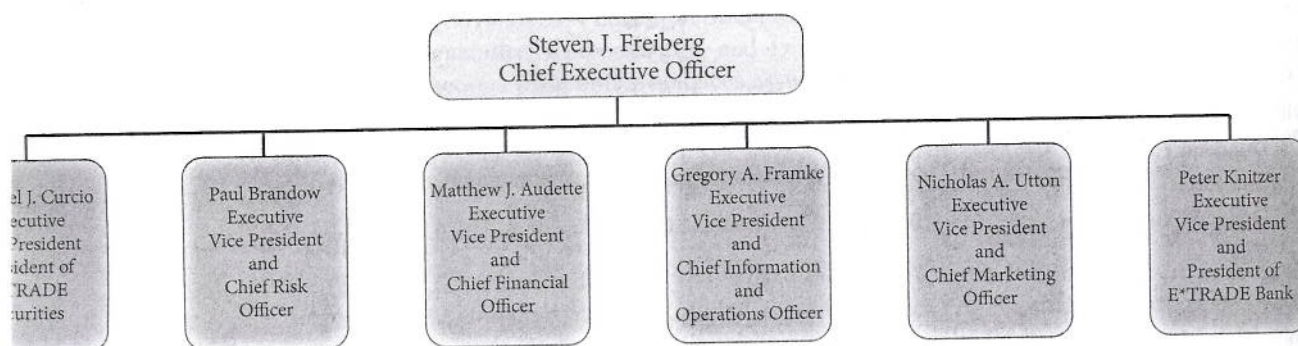
Significant segments of the company include E*TRADE Bank, E*TRADE Capital Markets, E*TRADE Clearing, and E*TRADE Securities. E*TRADE offers, either alone or with its partners, branded retail websites in the United States, Canada, Denmark, Finland, France, Germany, Hong Kong, Iceland, Italy, Sweden, the UAE, and the United Kingdom. E*TRADE has also licensed its name to companies that operate in Australia, Japan, and Korea. E*TRADE's primary retail products and services consist of 1) investing and trading, 2) banking, and 3) lending. In the company *Form 10K* (p. 44, 2010), E*TRADE reveals that it is transitioning to a two division company:

We report our operating results in two segments: 1) trading and investing, and 2) balance sheet management. Trading and investing includes retail brokerage products and services, investor-focused banking products, market making, and corporate services. Balance sheet management includes the management of asset allocation and credit, liquidity and interest rate risk, loans previously originated or purchased from third parties, and customer cash and deposits.

Finance

E*TRADE's total net revenue decreased from \$2.2 billion in 2009 to \$2.1 billion in 2010 due to a 16 percent decrease in operating interest revenue amounting to \$286 million. In fact, this revenue source decreased \$923 million, or 37 percent, since 2008. The firm lost \$1.3 billion in 2009, largely due to the loss on early extinguishment of debt. In 2010, the loss amounted to only \$28 million. Exhibit 3 and Exhibit 4 present E*TRADE's consolidated financial statements. Exhibit 5 provides E*TRADE's financials by segment.

BIT 2 Organizational Chart



Developed based on information from E*Trade.com.

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EXHIBIT 3 Income Statement (in thousands)

	Year ending Dec. 31,		
	2010	2009	2008
Revenue			
Operating interest income	\$1,546,713	\$1,832,558	\$2,469,940
Operating interest expense	(320,430)	(571,956)	(1,201,934)
Net operating interest income	<u>1,226,283</u>	<u>1,260,602</u>	<u>1,268,006</u>
Commissions	431,000	547,993	515,551
Fees and service charges	142,377	192,516	199,956
Principal transactions	103,346	88,053	84,882
Gains (losses) on loans and securities, net	166,212	169,106	(100,473)
Other-than-temporary impairment ("OTTI")	(41,510)	(232,139)	(95,010)
Less: noncredit portion of OTTI recognized into other comprehensive income (loss) (before tax)	<u>3,840</u>	<u>143,044</u>	<u>-</u>
Net impairment	(37,670)	(89,095)	(95,010)
Other revenues	46,327	47,841	52,684
Total noninterest income	851,592	956,414	657,590
Total net revenue	\$2,077,875	\$2,217,016	\$1,925,596
Provision for loan losses	779,412	1,498,112	1,583,666
Operating expense			
Compensation and benefits	325,044	366,232	383,385
Clearing and servicing	147,493	170,711	185,082
Advertising and market development	132,150	114,399	175,250
Professional services	81,177	78,718	94,070
FDIC insurance premiums	77,728	94,258	31,258
Communications	73,342	84,381	96,792
Occupancy and equipment	70,915	78,360	85,766
Depreciation and amortization	87,931	83,337	82,483
Amortization of other intangibles	28,475	29,737	35,746
Facility restructuring and other exit activities	14,346	20,652	29,502
Other operating expenses	<u>103,976</u>	<u>122,544</u>	<u>90,881</u>
Total operating expense	1,142,577	1,243,329	1,290,215
Income (loss) before other income (expense), income tax expense (benefit) and discontinued operations	155,886	(524,425)	(948,285)
Other income (expense)			
Corporate interest income	6,188	860	7,210
Corporate interest expense	(167,130)	(282,688)	(362,160)
Gains (losses) on sales of investments, net	2,655	(1,714)	(4,230)
Gains (losses) on early extinguishment of debt	-	(1,018,848)	10,084
Equity in income (loss) of investments and venture funds	(740)	(8,616)	18,462
Total other income (expense)	(159,027)	(1,311,006)	(330,634)
Loss before income tax expense (benefit) and discontinued operations	(3,141)	(1,835,431)	(1,278,919)
Income tax expense (benefit)	25,331	(537,669)	(469,535)

(continued)

EXHIBIT 3 continued

	Year ending Dec. 31,		
	2010	2009	2008
Loss from continuing operations	(28,472)	(1,297,762)	(809,384)
Income from discontinued operations, net of tax	—	—	297,594
Net loss	\$(28,472)	\$(1,297,762)	\$(511,790)
Basic loss per share from continuing operations	(0.13)	(11.85)	(15.88)
Basic earnings per share from discontinued operations	—	—	5.84
Basic net loss per share	(0.13)	(11.85)	(10.04)
Shares used in computation of per share data			
Basic	211,302	109,544	50,986

Source: 2010 10K Report

EXHIBIT 4 Balance Sheet (in thousands, except share amounts)

	For year ending 2010	Dec. 31, 2009
ASSETS		
Cash and equivalents	\$2,374,346	\$3,483,238
Cash and investments required to be segregated under federal or other regulations	609,510	1,545,280
Trading securities	62,173	38,303
Available-for-sale securities (includes securities pledged to creditors with the right to sell or repledge of \$5,621,156 and \$7,298,631 at December 31, 2010, and 2009, respectively)	14,805,677	13,319,712
Held-to-maturity securities (fair value of \$2,422,335 and includes securities pledged to creditors with the right to sell or repledge of \$884,214 at December 31, 2010)	2,462,710	—
Margin receivables	5,120,575	3,827,212
Loans, net (net of allowance for loan losses of \$1,031,169 and \$1,182,738 at December 31, 2010, and 2009, respectively)	15,127,390	19,174,933
Investment in FHLB stock	164,381	183,863
Property and equipment, net	302,658	320,169
Goodwill	1,939,976	1,952,326
Other intangibles, net	325,403	356,404
Other assets	3,078,202	3,165,045
TOTAL ASSETS	\$46,373,001	\$47,366,485
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities		
Deposits	25,240,297	25,597,721
Securities sold under agreements to repurchase	5,888,249	6,441,875
Customer payables	5,020,086	5,234,199
FHLB advances and other borrowings	2,731,714	2,746,959
Corporate debt	2,145,881	2,458,691
Other liabilities	1,294,329	1,137,485
TOTAL LIABILITIES	\$42,320,556	\$43,616,930

	For year ending 2010	Dec. 31, 2009
Shareholders' equity		
Common stock, \$0.01 par value, shares authorized 400,000,000 at December 31, 2010, and 4,000,000,000 at December 31, 2009; shares issued and outstanding 220,840,821 at December 31, 2010, and 189,397,099 at December 31, 2009	2,208	1,894
Additional paid-in-capital ("APIC")	6,640,715	6,275,157
Accumulated deficit	(2,151,838)	(2,123,366)
Accumulated other comprehensive loss	(438,640)	(404,130)
TOTAL SHAREHOLDERS' EQUITY	\$ 4,052,445	\$ 3,749,555
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 46,373,001	\$ 47,366,485

Source: 2010 10K Report.

EXHIBIT 5 E*TRADE Financials By-Segment

Dec. 31, 2009	Variance					
	Year Ended December 31			2010 vs 2009		
	2010	2009	2008	Amount	%	
\$3,483,238	Net operating interest income	\$763.0	\$699.6	\$800.3	\$63.4	9%
1,545,280	Commissions	431.0	548.0	514.7	(117.0)	(21)%
38,303	Fees and service charges	139.1	185.6	191.6	(46.5)	(25)%
13,319,712	Principal transactions	103.4	88.1	84.8	15.3	17%
	Other revenues	37.9	35.5	38.5	2.4	7%
	Total net revenue	1,474.4	1,556.8	1,629.9	(82.4)	(5)%
	Total operating expense	752.6	796.6	926.6	(44.0)	(6)%
	Trading and investing segment income	\$721.8	\$760.2	\$703.3	\$ (38.4)	(5)%
	Key Metrics					
	DARTs	150,532	179,183	169,075	(28,651)	(16)%
3,827,212	Average commission per trade	\$11.21	\$11.33	\$10.98	\$(0.12)	(1)%
19,174,933	Margin receivables (dollars in billions)	\$ 5.1	\$3.7	\$2.7	\$1.4	38%
	End of period brokerage accounts	2,684,311	2,630,079	2,515,806	54,232	2%
	Net new brokerage accounts	54,232	114,273	142,541	(60,041)	*
183,863	Customer assets (dollars in billions)	\$176.2	\$150.5	\$110.1	\$25.7	17%
320,169	Net new brokerage assets (dollars in billions)	\$8.1	\$7.2	\$3.9	\$ 0.9	*
1,952,326	Brokerage related cash (dollars in billions)	\$24.5	\$20.4	\$15.8	\$ 4.1	20%

Source: E*TRADE'S 2010 Form 10K, p.44.

Marketing

E*TRADE increased its advertising and marketing development expenditures by over 15 percent in 2010 to \$132.2 million as compared to \$114.4 million in 2009. E*TRADE returned to advertising during the Super Bowl in 2008. Since then, its Super Bowl ads have featured a talking baby, which has been a hit with TV viewers. In 2011, the company launched its "Investing Unleashed" advertising and marketing campaign, which utilizes traditional advertising mediums as well as social media channels.

E*TRADE uses co-branding to market its services at a discounted price. For example, E*TRADE and Hilton HHonors Worldwide have a marketing relationship that provides Hilton

HHonors members with HHonors bonus points when they open an account with E*TRADE. The agreement offers HHonors members the opportunity to earn 5,000 HHonors points when they open a new E*TRADE account, and enables E*TRADE to reach a large and highly attractive group of consumers with an expressed allegiance to one of the world's leading frequent-traveler programs.

Future

In February 2011, Citadel dropped its share of E*TRADE's stock to about 20 percent. Then in May 2011, Citadel sold off another 27.5 million shares of E*TRADE's stock to own about 9.5 percent of E*TRADE. Does Citadel Equity Fund know something that most people do not? It is interesting that Citadel's Ken Griffin is on E*TRADE's board. The stock market "crashed" the first ten days of August 2011.

To sustain and grow its competitive advantage, what strategies should E*TRADE pursue? Under the leadership of CEO Steven Frieberg, should E*TRADE expand its global trading platform to give customers access to over 42 international exchanges and related currencies? The company could also offer customers certificates of deposit in foreign currencies to give investors new opportunities to diversify their portfolios. Should E*TRADE focus on growth through acquiring another online brokerage firm to gain economies of scale and market share? E*TRADE is clearly in need of a turnaround strategy. How much is the company worth? Maybe E*TRADE should merge or be acquired by a larger bank or brokerage firm? What do you think?